

VIRGINIA MILITARY INSTITUTE

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2007**



AUDIT SUMMARY

Our audit of Virginia Military Institute for the year ended June 30, 2007, found:

- the financial statements are presented fairly, in accordance with generally accepted accounting principles;
- internal control matters that we consider to be significant deficiencies; however we do not consider these matters to be material weaknesses; and
- an instance of noncompliance required to be reported under Government Auditing Standards.

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INTERNAL CONTROL AND COMPLIANCE FINDINGS AND RECOMMENDATIONS

Improve Logical Access Policies and Procedures

The Institute does not consistently remove user accounts on sensitive and mission critical systems upon employee termination. The Institution implemented semi-annual user account reviews in response to our audit of the Institution's access controls in 2005. However, the Institute's user account removal policy and process lacks certain industry best practices, such as indicating a specific number of days after an employee has separated from the Institute for the employee's department to submit an account deletion request to the IT department.

We recommend that the Institute improve its logical access policies and procedures to require a certain time period for notifying IT of terminations, require immediate user account termination notification when the Institute does not give the employee advance notice of separation, and to train the Institute's supervisors in their responsibilities through the Institute's Security Awareness Program.

Properly Complete Employment Eligibility Verification Forms

Institute personnel are not properly completing Employment Eligibility Verification forms (I-9) in accordance with guidance issued by the US Citizenship and Immigration Services of the US Department of Homeland Security in its Handbook for Employers.

We checked the employment records of ten employees and while all employees were eligible for employment, we found the following.

- a. Two completed correctly,
- b. Five had Section 2 (Employer Review and Verification) improperly completed,
- c. Four did not have the employer's review and signature before or within three business days of the employment start date, and
- d. Five did not have the employee's signature before or on the employment start date.

We recommend that management develop a training program for all applicable employees on the requirements of completing the I-9 form. Management should also implement a process for monitoring accuracy in the I-9 process. The federal government has stepped up its enforcement efforts related to hiring illegal immigrants, which makes having a good I-9 process in place more important than ever before. Weaknesses in the I-9 process could result in fines and penalties against the Institution.

MANAGEMENT'S DISCUSSION AND ANALYSIS

(Unaudited)

Overview

Virginia Military Institute (VMI) is pleased to present its financial statements for the fiscal year ended June 30, 2007, along with the financial statements of its affiliates as required under Governmental Accounting Standards Board Statement 39. This management discussion and analysis is designed to help readers understand the accompanying financial statements and to provide an objective, easily readable analysis of the Institute's financial activities based on currently known facts, decisions and conditions. This discussion focuses primarily on VMI's fiscal year 2007 and includes highly summarized data that should be read in conjunction with the accompanying financial statements and notes to the financial statements.

VMI's financial statements are prepared in accordance with Governmental Accounting Standards Board (GASB) standards and include three basic statements: the Statement of Net Assets; the Statement of Revenues, Expenses, and Changes in Net Assets; and the Statement of Cash Flows. The affiliates' financial statements are prepared in accordance with Financial Accounting Standards Board (FASB) standards and include the Statement of Financial Condition and the Statement of Activities. The following analysis discusses elements from VMI's statements and provides an overview of the Institute's activities. It also includes a separate section that addresses the financial statements of VMI's affiliates.

Financial Highlights

The financial position of the Institute continues to get stronger, with assets of \$252.7 million and liabilities of \$29.9 million at June 30, 2007, compared to assets of \$157.4 million and liabilities of \$30.5 million at June 30, 2006. Net assets, which represent the residual interest in the Institute's assets after liabilities are deducted, increased \$96.0 million in the 2007 fiscal year, to \$222.9 million at June 30, 2007. Net assets increased by \$29.1 million during the 2006 fiscal year. This \$66.9 million improvement is largely attributable to state appropriations and private contributions received specifically for capital construction.

The increases in restricted—expendable net assets and the investment in capital assets, net of related debt accounts for nearly all of the increase in net assets. Of the \$96 million increase in net assets, \$50.1 million can be attributed to restricted—expendable while \$46 million is attributable to the investment in capital assets. This is the result of VMI's on-going capital improvement plan that includes the complete renovation of Nichols Engineering Hall, Cocke Hall Annex, Jackson Memorial Hall, Crozet Hall, emergency repairs to Barracks, the Football and Baseball Stadiums, Mallory Hall, Kilbourne Hall, storm water drainage improvements, an expansion to Barracks and a new Leadership and Ethics Center.

During the 2007 fiscal year, VMI commenced the construction of the Leadership and Ethics Center (\$21 million) and continued the Expansion and Renovation of Barracks project (\$60.8 million). The renovations of Crozet Hall (\$15.3 million), Nichols Engineering Hall (\$17.8 million), Jackson Memorial Hall (\$3.9 million), the storm water drainage improvements (\$1.3 million), renovation of Mallory Hall (\$12.9 million), and the renovation and expansion of Athletic facilities (\$20.5 million), were all completed during the 2007 fiscal year. The renovation and expansion of Kilbourne Hall (\$27.5 million) is still ongoing while the North Institute Hill Parking (\$2 million) will be completed early in the 2008 fiscal year.

Operating revenues increased by \$1.5 million over the preceding year or 6.1 percent, to \$26.3 million, and net non-operating revenues increased by \$2.2 million or 7.8 percent, to \$30.8 million. Operating expenses increased by \$2.7 million or 4.7 percent, to \$59.4 million. Other revenues increased by \$65.8 million or 202.5 percent in the 2007 fiscal year to \$98.3 million from \$32.5 million during the 2006 fiscal year. The largest portion of this increase in other revenues is attributable to a \$44.8 million increase in state

appropriations for capital projects while an additional \$21.2 million can be attributed to an increase in private gifts and grants for capital projects.

Statement of Net Assets

The Statement of Net Assets presents the financial position of the Institute at the end of the fiscal year and includes all assets and liabilities of the Institute. The difference between total assets and total liabilities—net assets—is one indicator of the current financial condition of the Institute, while the change in net assets is an indicator of whether the overall financial condition has improved or worsened during the year. Readers of the Statement of Net Assets should be able to determine the assets available to continue the Institute’s operations. They should also be able to determine how much the Institute owes vendors, creditors, and others.

Net Assets are divided into three major categories. The first category, “Invested in capital assets, net of related debt,” provides the Institute’s equity in property, plant, and equipment. The next category is “Restricted” net assets which comprise two subcategories, expendable and nonexpendable. Expendable restricted resources are available for expenditure by the Institute in accordance with stipulation of donors and/or other entities that have placed time or purpose restrictions on the use of the assets. Nonexpendable restricted resources typically represent the corpus of endowments and are available only for investment purposes. The final category is “Unrestricted” net assets which are available for any lawful purpose of the Institute.

Statement of Net Assets

	<u>June 30, 2007</u>	<u>June 30, 2006</u> <u>(Restated)</u>	<u>Variance</u>	
Assets:				
Current assets	\$ 15,957,175	\$ 16,810,761	\$ (853,586)	(5.1)%
Capital assets, net	150,175,297	110,219,165	39,956,132	36.3%
Other non-current assets	<u>86,616,185</u>	<u>30,324,142</u>	<u>56,292,043</u>	<u>185.6%</u>
Total assets	<u>252,748,657</u>	<u>157,354,068</u>	<u>95,394,589</u>	<u>60.6%</u>
Liabilities:				
Current liabilities	11,179,418	10,607,492	571,926	5.4%
Non-current liabilities	<u>18,712,152</u>	<u>19,855,538</u>	<u>(1,143,386)</u>	<u>(5.8)%</u>
Total liabilities	<u>29,891,570</u>	<u>30,463,030</u>	<u>(571,460)</u>	<u>(1.9)%</u>
Net Assets:				
Invested in capital assets, net of related debt	134,273,630	88,242,815	46,030,815	52.2%
Restricted - expendable	75,974,556	25,853,033	50,121,523	193.9%
Restricted - nonexpendable	4,267,843	4,267,460	383	0.0%
Unrestricted	<u>8,341,058</u>	<u>8,527,730</u>	<u>(186,672)</u>	<u>(2.2)%</u>
Total net assets	<u>\$222,857,087</u>	<u>\$126,891,038</u>	<u>\$95,966,049</u>	<u>75.6%</u>

VMI’s current assets decreased by \$.9 million, or 5.1 percent. Because of reporting guideline changes from the Treasury Department, amounts due from the Commonwealth for General Obligation Bond (GOB) funded projects as well as projects funded through the Virginia College Building Authority (VCBA) were restated for the 2006 fiscal year, requiring the Institute to reflect an additional \$3.1 million due from the Commonwealth for the Nichols Hall, Kilbourne Hall and Mallory Hall projects as of June 30, 2006, for expenses incurred during 2006 and reimbursed in fiscal year 2007. At the end of the 2007 fiscal year, only

\$.1 million was due from the Commonwealth for these GOB and VCBA funded projects. This decrease is partially offset by an increase in cash and cash equivalents attributed to the return of endowment proceeds earmarked for capital projects. The Leadership and Ethics Center is funded with bond proceeds as well as endowment proceeds. Because the bond proceeds must be used within a given time frame, the endowment proceeds were returned to current assets until the bond proceeds are depleted. Additionally, inventories increased during the 2007 fiscal year as a result of the U.S. Army's uniform conversion from Battle Dress Uniforms (BDU's) to Army Combat Uniforms (ACU's).

Capital assets, net of depreciation, increased by \$40 million to \$150.2 million as the result of the completion of several large capital projects. In addition to amounts previously capitalized as construction in progress, the following increases were recorded: \$9.3 million Nichols Hall, \$7.6 million Crozet Hall, \$.4 million Foster Stadium, \$6.9 million Gray-Minor Baseball Stadium, \$4.2 million storm water drainage, \$2.4 million Cocke Hall Annex, \$2.5 million Jackson Memorial Hall, and \$5.2 million Hinty Hall.

Other noncurrent assets increased by \$56.3 million to \$86.6 million as a result of general fund support received from the Commonwealth for the expansion and renovation of Barracks and the renovation of Mallory Hall.

Current liabilities increased slightly, \$.6 million, over the previous year to \$11.2 million. Salaries and benefits payable as of the end of the 2007 fiscal year increased by \$1.8 million as a result of the last payroll of the fiscal year being paid in July. Because of the 2006 budget impasse, the Governor directed the final payroll of fiscal year 2006 to be paid in June rather than accrued and paid in the following fiscal year. This increase was partially offset by a decrease in accounts payable of \$1.1 million as a result of the completion of several capital projects.

Noncurrent liabilities decreased \$1.1 million to \$18.7 million as a result of less retainage held for capital projects and the payment of principal amounts due for notes and bonds payable.

Net assets totaled \$222.9 million at year end. This represented an increase of \$96 million over the previous year, due largely to the increase of capital assets as a result of construction, and the additional general fund support received from the Commonwealth for other capital projects.

Statement of Revenues, Expenses, and Changes in Net Assets

Changes in the total net assets as presented on the Statement of Net Assets are based on the activity presented in the Statement of Revenues, Expenses, and Changes in Net Assets. The purpose of this statement is to present the Institute's operating and non-operating revenues recognized and expenses paid and any other revenues, expenses, gains, and losses received or incurred by the Institute.

Operating revenues are generally recognized when goods and services are provided to cadets and other constituencies of the Institute. Operating expenses are the cost incurred to acquire or produce the goods and services provided and to carry out the Institute's programs and activities.

Non-operating revenues generally represent income and support for which goods and services are generally not provided. For example, it includes State appropriations for VMI's Educational and General and Unique Military Activities Programs for which goods and services are not directly provided to the State by VMI.

Statement of Revenues, Expenses, and Changes in Net Assets

	<u>June 30, 2007</u>	<u>June 30, 2006</u> <u>(Restated)</u>	<u>Variance</u>	
Operating revenues:				
Tuition and fees	\$ 12,031,383	\$ 11,188,980	\$ 842,403	7.5%
Grants and contracts	947,051	1,211,097	(264,046)	(21.8)%
Auxiliary enterprises	10,653,102	9,686,439	966,663	10.0%
Unique military activities	1,482,892	1,399,448	83,444	6.0%
Other sources	<u>1,150,297</u>	<u>1,257,202</u>	<u>(106,905)</u>	<u>(8.5)%</u>
Total operating revenues	<u>26,264,725</u>	<u>24,743,166</u>	<u>1,521,559</u>	<u>6.1%</u>
Operating expenses:				
Educational and general	37,812,377	37,047,094	765,283	2.1%
Auxiliary enterprises	16,757,487	14,975,541	1,781,946	11.9%
Unique military activity	4,840,824	4,747,963	92,861	2.0%
Loan cancellations and write-offs	<u>17,245</u>	<u>-</u>	<u>17,245</u>	<u>-</u>
Total expenses	<u>59,427,933</u>	<u>56,770,598</u>	<u>2,657,335</u>	<u>4.7%</u>
Operating loss	(33,163,208)	(32,027,432)	(1,135,776)	3.5%
Non-operating revenues (expenses):				
State appropriations	13,565,769	12,971,013	594,756	4.6%
Gifts and contributions	14,862,389	13,629,188	1,233,201	9.0%
Investments	3,556,303	2,037,749	1,518,554	74.5%
Other	<u>(1,201,408)</u>	<u>(73,233)</u>	<u>(1,128,175)</u>	<u>(1540.5)%</u>
Net non-operating revenues	<u>30,783,053</u>	<u>28,564,717</u>	<u>2,218,336</u>	<u>7.8%</u>
Income (loss) before other revenues	<u>(2,380,155)</u>	<u>(3,462,715)</u>	<u>1,082,560</u>	<u>(31.3)%</u>
Other revenues	<u>98,346,204</u>	<u>32,513,984</u>	<u>65,832,220</u>	<u>202.5%</u>
Increase (decrease) in net assets	95,966,049	29,051,269	66,914,780	230.3%
Net assets - beginning of year	<u>126,891,038</u>	<u>97,839,769</u>	<u>29,051,269</u>	<u>29.7%</u>
Net assets - end of year	<u>\$222,857,087</u>	<u>\$126,891,038</u>	<u>\$95,966,049</u>	<u>75.6%</u>

Operating revenues totaled \$26.3 million, an increase of \$1.5 million or 6.1 percent. A 7.5 percent increase in total tuition and fee revenue (\$.8 million) and a 10 percent increase in auxiliary enterprise revenue (\$1 million) can be attributed to tuition and fee increases of 7.5 percent for in-state cadets (56.2 percent of the Corps) and 5.9 percent for out-of-state cadets (43.8 percent of the Corps).

Operating expenses increased by \$2.7 million, or 4.7 percent, to \$59.4 million. Educational and general program expenses increased by \$.8 million, or 2.1 percent. Auxiliary enterprise expenses increased \$1.8 million, or 11.9 percent, largely attributable to an increase in depreciation expense for new auxiliary facilities, Crozet Hall, Foster Stadium and Gray-Minor Baseball Stadium (\$510,000), a rate increase from VMI's food service vendor, Aramark (\$300,000), and an increase in personal service costs for Athletics due to the creation of a Chief of Staff for Athletics position and a contract payoff for the previous football coach (\$370,000).

Non-operating revenues total \$30.8 million, an increase of \$2.2 million, or 7.8 percent. Gifts and contributions increased \$1.2 million as a result of additional support received from the Alumni Agencies for unrestricted and restricted funds. Investment income increased by \$1.5 million to \$3.6 million, mostly attributable to realized gains on investments. Other revenues within the non-operating revenue category decreased by \$1.1 million as a result of a loss on the disposal of plant assets due primarily to the demolition of Lejeune Hall, the residence at 208 Maiden lane, and the outdoor track. These facilities were demolished to make way for other structures and improvements.

Other revenues total \$98.3 million, an increase of \$65.8 million, or 202.5 percent. Private funds from the VMI Foundation for capital projects increased by \$21.2 million while State support for capital projects increased by \$44.8 million.

Statement of Cash Flows

This statement presents detailed information about the Institute's cash activity during the year. It is divided into five parts: operating activities, noncapital financing activities, investing activities, capital and related financing activities, and reconciliation of the net cash used to the operating income or loss reflected on the Statement of Revenues, Expenses, and Changes in Net Assets.

Statement of Cash Flows

	June 30, 2007	June 30, 2006 (Restated)	Variance	
Net cash used by operating activities	\$(27,216,018)	\$(29,749,367)	\$ 2,533,349	8.5%
Net cash provided by non-capital financing activities	28,458,918	26,821,243	1,637,675	6.1%
Net cash provided by capital and related financing activities	54,887,201	(1,370,669)	56,257,870	>100%
Net cash provided by investing activities	<u>1,488,158</u>	<u>1,411,023</u>	<u>77,135</u>	<u>5.5%</u>
Net increase (decrease) in cash	57,618,259	(2,887,770)	60,506,029	>100%
Cash - beginning of year	<u>15,858,844</u>	<u>18,746,614</u>	<u>(2,887,770)</u>	<u>(15.4)%</u>
Cash - end of year	<u>\$ 73,477,103</u>	<u>\$ 15,858,844</u>	<u>\$57,618,259</u>	<u>363.3%</u>

Cash provided and/or (used) by operating activities will always result in a net use for the Institute because all state appropriations and private gifts are treated as cash sources for noncapital or capital financing activities. Tuition and fees alone represents more than 91 percent of the cash sources for operating activities while all expenses for operating activities are reflected in this section of the Statement of Cash Flows.

Net cash provided from noncapital financing activities consists largely of State and private fund support of operations. Nearly all of the \$1.6 million increase over the previous fiscal year can be attributed to the budgeted increase in support received from the VMI Alumni Agencies.

The \$54.9 million of net cash provided by capital and related financing activities consists primarily of state appropriations, gifts and contributions from the VMI Foundation and proceeds from capital debt received for capital projects (Mallory Hall, Kilbourne Hall, Expansion of Barracks, improvements to Alumni Memorial Stadium and Patchin Fields, and the new Leadership and Ethics Center), less amounts expended for these projects and their related debt obligations.

The \$1.5 million in net cash provided by investing activities primarily reflects spendable income from VMI's endowment assets that support various programs and activities.

Capital Asset and Debt Administration

Fiscal year 2007 was the fifth year of VMI's Vision 2039 capital projects program and is expected to continue for the remainder of this decade. During the year, planning and/or renovation and construction occurred on several academic facilities as well as other mission essential facilities: Nichols Engineering Hall (\$17.8 million), Mallory Hall (\$12.9 million), Kilbourne Hall (\$20.9 million), Jackson Memorial Hall (\$3.9 million), Cocke Hall Annex (\$2.2 million), a new Leadership and Ethics Center (\$21 million), and the renovation and expansion of Barracks (\$60.8 million).

The Nichols Engineering Hall and the Mallory Hall projects were funded from the State's 2002 General Obligation Bonds (GOB) with some additional funding received from the State's general fund. The main Nichols Engineering Hall building was completed in August 2005 and returned to service; the annexes were completed in July 2006. The Mallory Hall renovation project was completed in August 2007.

The Kilbourne Hall project consists of three components: the construction of a new Physical Plant facility; the renovation and expansion of Kilbourne Hall and the renovation of the old Buildings and Grounds facility; and improvements to storm water lines along Main Street (this storm water project also included additional funding of \$1.3 million from a separate storm water project). Construction on the new Physical Plant facility began in September 2005 and construction on the storm water project began in October 2005. The new Physical Plant facility was completed in September 2006 and the storm water project was completed in December 2006. The Kilbourne Hall renovation and old Buildings and Grounds facility renovation and expansion component started in October 2006 and are scheduled to be done in phases. The first phase, renovation of the old Buildings and Grounds facility and expansion of Kilbourne Hall, is scheduled to be completed in December 2007 and the second phase, renovation of Kilbourne Hall, is scheduled to be completed in July of 2008. The Kilbourne Hall project is funded predominantly by State general funds with some support from private funds received through the VMI Foundation.

The Jackson Memorial Hall and Cocke Hall Annex projects were completed in July 2006. These two projects were financed under the Virginia College Building Authority (VCBA) "pooled bond" program in 2002 with debt service being funded from cadet fees and private funds.

Planning began in fiscal year 2005 for the Leadership and Ethics Center which began construction in October 2006 with completion scheduled for November 2008. This project is being financed by one of VMI's alumni agencies and from a private gift to VMI; VMI will not incur any debt on this project.

VMI also had two major auxiliary enterprise projects: the renovation and expansion of Crozet Hall (\$14.6 million) and the renovation of the VMI football and baseball stadiums (\$20 million). Crozet Hall is VMI's sole dining facility (mess hall) and was completed in July 2006. A major component of this project was a new kitchen which was completed and placed in service in October 2005. This project was financed with State revenue bonds (9c debt) and debt service is being funded from VMI private funds. The stadiums project began construction in October 2005 and is scheduled to be completed in October 2007. This project is being financed by one of VMI's alumni agencies; VMI will not incur any debt on this project.

The 2005 General Assembly appropriated \$1.9 million of State funds to begin planning the renovation and expansion of the VMI Barracks. During the 2006 fiscal year, the General Assembly appropriated \$46.8 million to expand the Barracks as well as renovate the existing Barracks. During 2007, the General Assembly appropriated an additional \$14 million for the Barracks project. This will provide

much needed repairs and upgrades to this historic building and allow VMI to grow the Corps to 1,500 cadets beginning in Fall 2010. The addition to Barracks is scheduled to be completed in July 2008 and the renovation is scheduled for completion in August 2009.

In October 2006, the North Institute Hill Parking project (\$2 million) got underway. This surface parking facility was funded from private sources and was completed in September 2007.

In summary, VMI had approximately \$115.6 million in capital projects in progress at the end of June 2007, Mallory Hall, Kilbourne Hall, Renovation and Expansion of Barracks, and the Leadership and Ethics Center. These projects are being funded mostly from State and private sources. VMI has incurred debt on only the Jackson Memorial Hall, Cocke Hall Annex, and Crozet Hall projects. The debt on these projects totals approximately \$15.6 million and results in annual debt service payments of \$1.3 million. VMI's Board of Visitors adopted debt guidelines in August 2005 to help ensure sound management and control of debt.

Affiliates' Financial Statements

VMI's affiliates consist of the VMI Alumni Agencies (VMIAA) and the VMI Research Laboratories, Inc. (VMIRL). The VMIAA is comprised of four separate entities: the VMI Alumni Association, the VMI Foundation, Inc., the VMI Development Board, Inc., and the VMI Keydet Club, Inc. These entities share a common purpose of raising funds, investing funds, and performing other activities in support of VMI, and accordingly, present their financial statements on a combined basis. The VMIRL exists to administer grant and contract research, symposia, and other educational programs at VMI.

Total net assets of the VMIAA and the VMIRL amounted to \$348.7 million and \$.3 million, respectively, as of June 30, 2007 as compared to \$321 million and \$.5 million as of June 30, 2006. VMIAA net assets consist of \$51.1 million in unrestricted net assets and \$297.6 million in temporarily and permanently restricted net assets. VMIAA revenues totaled \$24.3 million for fiscal year 2007 and \$23.7 million for fiscal year 2006. The amount the VMIAA remitted directly to or on behalf of VMI for fiscal year 2007 was \$39.1 million compared to \$24.5 million for fiscal year 2006, a 59.6 percent increase. This increase can be attributed to additional funds provided for capital improvements to the Football and Baseball Stadiums, the renovation of Kilbourne Hall, North Institute Hill Parking, and the Leadership and Ethics Center.

Economic Outlook

State appropriations provided 23.3 percent of VMI's total revenue and support for operations in fiscal year 2007 and 24.3 percent in fiscal year 2006. State appropriations were increased approximately \$1.6 million for fiscal year 2008 to cover the State's share of cost increases related to salary and fringe benefit increases approved by the General Assembly, in-state student enrollment growth, and operating costs for new or renovated facilities coming on-line. This also included additional State funds for VMI's Unique Military Activities (UMA) Program of \$460,000. However, as a result of a subsequent \$641 million shortfall in the State's 2006-2008 Biennial Operating Budget, the Governor reduced State appropriations to agencies and institutions in October 2007 that apply to fiscal year 2008 and the upcoming 2008-2010 biennium. VMI's reduction is approximately \$902,000 and will require a reduction in discretionary spending and maximization of savings from employee vacancies and turnover. State appropriations for fiscal year 2008 are projected to provide approximately 25 percent of total revenue and support for operations.

VMI's Six-Year Institutional Plan was submitted to the State on September 28, 2007 (as required by the 2005 Restructured Higher Education Financial and Administrative Operations Act) and describes VMI's needs for additional State funds for on-going operations and new initiatives through 2014. Many of the new initiatives are for accreditation and administrative mandates.

State appropriations provided funding for capital projects of \$65.89 million in fiscal year 2007 and \$22.9 million in fiscal year 2006. The 2007 General Assembly appropriated \$15.0 million in State funds for VMI capital projects in fiscal year 2008 consisting of \$14.0 million in supplemental funds for the Barracks expansion/renovation project and \$989,000 in equipment funds for the Mallory Hall renovation project. VMI's Six-Year Capital Budget Requests for 2008-2014 submitted to the State in April 2007 includes \$42.7 million for three major projects consisting of \$15.3 million for Military and Leadership Field Training Grounds, \$18.3 million for Science Building renovations, and \$9.1 million for Public Safety and Security Improvements.

Private fund support from VMI's alumni agencies represented approximately 26 percent of VMI's total revenues and support for operations. Private support for operations is projected to provide approximately 29 percent in fiscal year 2008 with some modest increase in the following years. Private fund support for capital projects totaled \$32.5 million in fiscal year 2007 and \$11.3 million in fiscal year 2006. This support is expected to approximate \$13.3 million in fiscal year 2008 and reflects VMI alumni agencies' continued debt financing of the new Leadership and Ethics Center.

VMI increased fiscal year 2008 tuition and fees by 4.9 percent for in-state cadets and 5.9 percent for out-of-state cadets. VMI estimates that increases for fiscal year 2009 will be higher due primarily to increasing operating costs and a continued decline in the proportion of out-of-state cadets in the Corps (out-of-state cadets pay significantly greater tuition than in-state cadets). VMI plans to enhance its efforts to increase the enrollment of out-of-state cadets consistent with its planned enrollment projections that have been approved by the State. VMI also continues to improve the efficiency and effectiveness of all its programs.

VMI enrolled 1,408 cadets in fall 2007 consisting of 58.6 percent in-state cadets. VMI estimates an enrollment of approximately 1,410 cadets in fall 2008 with growth to approximately 1,500 cadets (57 percent in-state cadets) by fall 2011 as the completion of the Barracks expansion and renovation allows for a larger Corps.

VMI's executive management believes that the Institute is well positioned to continue to provide excellent programs and services to its cadets as it maintains a clear educational focus and a well-established niche in the higher education marketplace. The Board and the Superintendent continue to focus efforts and resources to sustain and enhance VMI's academic, military, leadership, and athletic programs and facilities consistent with their commitment to the goals outlined in "Vision 2039," an aggressive strategy to ensure that the Institute continues to serve the State and the Nation by graduating "citizen-soldiers" prepared for the responsibilities of citizenship and leadership.

FINANCIAL STATEMENTS

VIRGINIA MILITARY INSTITUTE
STATEMENT OF NET ASSETS
As of June 30, 2007

ASSETS	
Current assets	
Cash and cash equivalents (Note 2)	\$ 8,606,976
Cash equivalents held by Treasurer of Virginia (Note 2)	241,640
Collateral held for securities lending (Note 2)	951,956
Accounts receivable, net of allowance for doubtful accounts of \$55,679 (Note 3)	807,534
Notes receivable	210,000
Due from the Commonwealth (Note 8)	134,511
Prepaid expenditures	773,820
Inventory (Note 4)	3,990,751
Loans receivable	239,987
Total current assets	15,957,175
Noncurrent assets	
Cash and cash equivalents (Note 2)	64,870,127
Cash and investment with trustees (Note 2)	20,755,896
Cash equivalent held with the Treasurer of Virginia (Note 2)	3,610
Loans receivable, net of allowance for doubtful accounts of \$26,245	986,552
Nondepreciable capital assets (Note 5)	37,912,806
Depreciable capital assets, net of accumulated depreciation (Note 5)	112,262,491
Total noncurrent assets	236,791,482
Total assets	252,748,657
LIABILITIES	
Current liabilities	
Accounts payable and accrued expenses (Note 6)	6,810,172
Unearned revenue	927,078
Obligations under securities lending	1,193,596
Deposits held for others	526,364
Long-term liabilities-current portion: (Note 7)	
Compensated absences	864,708
Bonds payable (Note 8)	380,000
Notes payable (Note 8)	440,000
Capital lease payable (Note 8)	5,527
Installment purchase obligations (Note 8)	31,973
Total current liabilities	11,179,418
Noncurrent liabilities	
Accrued liabilities (Note 6)	632,926
Federal loan program contributions refundable	1,293,689
Retainage payable (Note 9)	1,278,312
Long-term liabilities-noncurrent portion: (Note 7)	
Compensated absences	490,774
Bonds payable (Note 8)	10,702,153
Notes payable (Note 8)	4,219,658
Capital lease payable (Note 8)	20,204
Installment purchase obligations (Note 8)	74,436
Total noncurrent liabilities	18,712,152
Total liabilities	29,891,570

VIRGINIA MILITARY INSTITUTE
STATEMENT OF NET ASSETS
As of June 30, 2007

NET ASSETS	
Invested in capital assets, net of related debt	134,273,630
Restricted-nonexpendable	
Endowment	4,267,843
Restricted-expendable	
Scholarships and other	2,007,574
Loan funds	582,363
Quasi-endowment-restricted	13,015,722
Capital projects	60,368,897
Unrestricted	8,341,058
	<hr/>
Total net assets	\$ 222,857,087
	<hr/>

The accompanying Notes to Financial Statements are an integral part of this statement.

VIRGINIA MILITARY INSTITUTE-COMPONENT UNITS
 COMBINED STATEMENT OF FINANCIAL POSITION
 As of June 30, 2007

ASSETS	
Current assets:	
Cash and cash equivalents	\$ 13,912,679
Contributions receivable (Note 17)	6,206,271
Accounts receivable	134,527
Other	407,720
Total current assets	20,661,197
Noncurrent assets:	
Contributions receivable (Note 17)	10,989,741
Notes receivable	20,799
Investments held by trustees (Note 17)	333,392,423
Investments, other (Note 17)	18,815,804
Investment securities	118,477
Funds restricted for affiliate	12,476,558
Cash surrender of life insurance	4,635,178
Property and equipment, net of accumulated depreciation	439,547
Total noncurrent assets	380,888,527
Total assets	\$ 401,549,724
LIABILITIES	
Current liabilities:	
Accounts payable and accrued liabilities	\$ 648,879
Long-term liabilities-current portion:	
Trust and annuity obligations	827,405
Total current liabilities	1,476,284
Noncurrent liabilities:	
Unearned revenue	16,475
Other liabilities	293,084
Long-term liabilities-noncurrent portion:	
Bonds payable (Note 17)	45,187,836
Trust and annuity obligations	5,592,400
Total noncurrent liabilities	51,089,795
Total liabilities	52,566,079
NET ASSETS	
Unrestricted	51,348,186
Temporarily restricted	197,637,083
Permanently restricted	99,998,376
Total net assets	348,983,645
Total liabilities and net assets	\$ 401,549,724

The accompanying Notes to Financial Statements are an integral part of this statement.

VIRGINIA MILITARY INSTITUTE
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For the Year Ended June 30, 2007

Operating revenues:	
Tuition and fees, net of scholarships allowances of \$3,655,611	\$ 12,031,383
Federal grants and contracts	925,954
State and private grants and contracts	21,097
Sales and services of educational departments	76,925
Auxiliary enterprise, net of scholarship allowances of \$3,014,276	10,653,102
Unique military activities, net of scholarships allowances of \$456,061	1,482,892
Other sources:	
Museum programs	513,802
Rents and commissions	183,337
Miscellaneous	376,233
Total operating revenues	<u>26,264,725</u>
Operating expenses:	
Educational and general:	
Instruction	16,321,053
Research	372,415
Public service	1,332,558
Academic support	5,496,210
Student services	3,112,838
Institutional support	4,653,951
Operation and maintenance of physical plant	5,744,467
Scholarships and related expense	778,885
Auxiliary enterprises	16,757,487
Unique military activities	4,840,824
Loan cancellations and write-offs	17,245
Total operating expenses (Note 10)	<u>59,427,933</u>
Net operating income (loss)	<u>(33,163,208)</u>
Nonoperating revenues/(expenses):	
State appropriations (Note 11)	13,565,769
Gifts and contributions	14,862,389
Investment income (loss)	3,556,303
Interest on capital asset - related debt	(341,170)
Loss on disposal of plant assets	(860,238)
Net nonoperating revenues	<u>30,783,053</u>
Income (loss) before other revenues	<u>(2,380,155)</u>
Other revenues:	
State appropriations-capital	65,828,725
Grants and contributions-capital	32,509,750
Investment income-capital	7,729
Total other revenues	<u>98,346,204</u>
Increase in net assets	95,966,049
Net assets beginning of the year, as restated (Note 1 M)	<u>126,891,038</u>
Net assets end of year	<u>\$ 222,857,087</u>

The accompanying Notes to Financial Statements are an integral part of this statement.

VIRGINIA MILITARY INSTITUTE-COMPONENT UNITS
 COMBINED STATEMENT OF ACTIVITIES
 For the Year Ended June 30, 2007

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
REVENUES:				
Amounts raised on behalf of VMI	\$ 8,005,091	\$ 6,345,244	\$ 3,576,825	\$ 17,927,160
Grants, contributions and contracts	124,587	40,000	-	164,587
Investment income	3,710,385	2,299	-	3,712,684
Actuarial loss on trust and annuity obligations	(109,511)	(468,123)	(95,062)	(672,696)
Unrealized loss on swap contract	-	(45,206)	-	(45,206)
Administrative fees	3,367,471	-	-	3,367,471
Other Income	499,061	-	-	499,061
Net assets released from restrictions and reclassification	7,722,726	(7,722,726)	-	-
Total revenues	23,319,810	(1,848,512)	3,481,763	24,953,061
EXPENSES:				
Amounts remitted directly to or on behalf of VMI:				
Unrestricted	30,692,565	-	-	30,692,565
Designated	8,432,934	-	-	8,432,934
Cost of operations	5,103,820	-	-	5,103,820
Conference, research and education	800,874	-	-	800,874
Total expenses	45,030,193	-	-	45,030,193
Change in net assets before net realized and unrealized gains on investments	(21,710,383)	(1,848,512)	3,481,763	(20,077,132)
Net realized and unrealized gains on investments	13,881,610	33,674,360	-	47,555,970
Change in net assets	(7,828,773)	31,825,848	3,481,763	27,478,838
Net assets beginning of year	59,176,959	165,811,235	96,516,613	321,504,807
Net assets end of year	<u>\$ 51,348,186</u>	<u>\$ 197,637,083</u>	<u>\$ 99,998,376</u>	<u>\$ 348,983,645</u>

VIRGINIA MILITARY INSTITUTE

STATEMENT OF CASH FLOW

For the Year Ended June 30, 2007

Cash provided/(used) by operating activities:	
Tuition and fees	\$ 11,905,503
Federal grants and contracts	1,065,118
State and private grants and contracts	21,097
Sales and services-educational and general	64,639
Auxiliary charges	10,708,708
Unique military activity charges	1,483,356
Other operating receipts	1,140,188
Payments to employees for salaries and benefits	(31,753,983)
Payments for supplies and services	(21,050,397)
Payments for scholarships and fellowships	(883,146)
Loans issued to students	(237,936)
Collections of loans from students	320,835
Net cash used by operating activities	(27,216,018)
Cash provided/(used) by noncapital financing activities:	
State appropriations	13,565,769
Gifts and grants for other than capital purposes	15,173,243
Federal Direct Lending Program-receipts	3,259,524
Federal Direct Lending Program-disbursements	(3,259,524)
Agency receipts	3,348,738
Agency disbursements	(3,628,832)
Net cash provided by noncapital financing activities	28,458,918
Cash provided/(used) by capital and related financing activities:	
Capital appropriations	65,828,725
Capital gifts and contributions	35,578,244
Proceeds from sale of capital assets	35,183
Proceeds from capital debt	1,353,231
Purchase and construction of capital assets	(46,745,881)
Principal paid on capital debt, leases and installments	(821,655)
Interest paid on capital debt, leases and installments	(342,420)
Investment income-capital	1,774
Net cash provided by capital and relating financing activities	54,887,201
Cash provided/(used) by investing activities:	
Interest income	324,573
Investment/Endowment income	285,936
Sale of investments	900,531
Purchase of investments	(22,882)
Net cash provided by investing activities	1,488,158
Net increase in cash	57,618,259
Cash-beginning of year, as restated	15,858,844
Cash-end of year	\$ 73,477,103

The accompanying Notes to Financial Statements are an integral part of this statement.

RECONCILIATION OF NET OPERATING EXPENSES TO NET CASH
USED BY OPERATING ACTIVITIES:

Net operating loss	\$ (33,163,208)
Adjustments to reconcile net operating expenses to cash used by operating activities:	
Depreciation expense	4,359,420
Changes in net assets and liabilities:	
Accounts receivable	171,550
Inventories	(679,687)
Prepaid expenditures	(60,119)
Due from Commonwealth	189,219
Accounts payable and accrued liabilities	1,721,687
Deposits held in custody for others-security deposits	55,446
Unearned revenue	4,703
Loans receivable	66,636
Compensated absences	84,826
Federal loan program contributions refundable	33,509
	<u> </u>
Net cash used in operating activities	<u><u>\$ (27,216,018)</u></u>
Noncash investing, noncapital financing, and capital related financing transactions:	
Fixed asset acquired by donation	170,829
Change in fair value of investments recognized as a component of investment income	<u>589,825</u>
	<u> </u>
Total	<u><u>\$ 760,654</u></u>
Reconciliation of cash and cash equivalents to the Statement of Net Assets:	
Cash and cash equivalents classified as current assets	8,606,976
Cash and cash equivalents classified as noncurrent assets	<u>64,870,127</u>
	<u> </u>
Total cash and cash equivalents	<u><u>\$ 73,477,103</u></u>

The accompanying Notes to Financial Statements are an integral part of this statement.

NOTES TO FINANCIAL STATEMENTS

VIRGINIA MILITARY INSTITUTE

NOTES TO THE FINANCIAL STATEMENTS

AS OF JUNE 30, 2007

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements of Virginia Military Institute (VMI) have been prepared in accordance with generally accepted accounting principles for colleges and universities. The significant accounting policies followed by the Institute are as follows:

A. Reporting Entity

The Virginia Military Institute believes that the measure of a college lies in the quality and performance of its graduates and their contributions to society. Therefore, it is the mission of the Virginia Military Institute to produce educated, honorable men and women prepared for the varied work of civil life, imbued with love of learning, confident in the functions and attitudes of leadership, possessing a high sense of public service, advocates of the American Democracy and free enterprise system, and ready as citizen-soldiers to defend their country in time of national peril.

To accomplish this result, Virginia Military Institute shall provide to qualified young men and women undergraduate education of highest quality – embracing engineering, science, and the arts – conducted in, and facilitated by, the unique VMI system of military discipline.

Virginia Military Institute is part of the Commonwealth of Virginia's statewide system of public higher education. The Board of Visitors, appointed by the Governor, is responsible for overseeing the Institute's governance. A separate report is prepared for the Commonwealth of Virginia which includes all agencies, boards, commissions, and authorities over which the Commonwealth exercises or has the ability to exercise oversight authority. The Institute is a component unit of the Commonwealth of Virginia and is included in the general purpose financial statements of the Commonwealth.

The Governmental Accounting Standards Board (GASB) Statement 39, *Determining Whether Certain Organizations Are Component Units*, became effective for the fiscal year ended June 30, 2004. This statement amended GASB Statement 14, *The Financial Reporting Entity*. GASB Statement 39 provides guidance to determine whether certain organizations for which the Institute is not financially accountable should be reported as component units. Generally, it requires reporting as a component unit, an organization that raises and holds economic resources for the direct benefit of the Institute.

The VMI Alumni Agencies is a legally separate, tax-exempt entity whose purpose is to organize the alumni of the Institute and to aid in the promotion of its welfare and the successful prosecution of its educational purposes. It accomplishes this through fund-raising

to supplement the support VMI receives from the Commonwealth of Virginia and the tuition and fees charged to cadets. Because the VMI Alumni Agencies' resources are held almost entirely for the benefit of the Institute and these resources are considered significant to the Institute, the Alumni Agencies are included as a component unit.

The VMI Research Laboratories (VMIRL) is a legally separate, tax-exempt entity whose purpose is to administer contract and grant research at the Institute. Because of the VMIRL's close relationship to the Institute, it is included as a component unit in our financial statements. Both the VMI Alumni Agencies and the VMIRL have been discretely presented in these statements.

Because the VMI Alumni Agencies and the VMIRL report under a different reporting model, the Financial Accounting Standards Board (FASB) standards, the VMI Board of Visitors and the administration of the Institute believe the Institute's financial statements should be presented on a page separate from the Institute's component units as allowed by GASB Statement 39. Separate financial statements for the VMI Alumni Agencies may be obtained by writing the Chief Financial Officer, VMI Foundation, Inc., P.O. Box 932, Lexington, Virginia 24450. Separate financial statements for the VMI Research Laboratories, Inc., may be obtained by writing the Treasurer, VMI Research Laboratories, Inc., Virginia Military Institute, Lexington, Virginia 24450.

B. Financial Statement Presentation

The Institute's accounting policies conform with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB) pronouncements as well as applicable Financial Accounting Standards Board (FASB) statements and interpretations, Accounting Principles Board opinions, and Accounting Research Bulletins of the Committee on Accounting Procedures issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The financial statements have been prepared in accordance with GASB Statement 34, *Basic Financial Statements and Management Discussion and Analysis for State and Local Governments*, and GASB Statement 35, *Basic Financial Statements and Management's Discussion and Analysis for Public Colleges and Universities*.

The VMI Alumni Agencies and the VMI Research Laboratories, Inc. are private, nonprofit organizations that report under FASB standards including FASB Statement 117, *Financial Reporting for Not-for-Profit Organizations*. As such, certain revenue recognition criteria and presentation features are different from GASB revenue recognition criteria and presentation features. No modifications have been made to the VMI Alumni Agencies' or the VMI Research Laboratories' financial information in the Institute's financial report for these differences.

C. Basis of Accounting

For financial statement purposes, the Institute is considered a special-purpose government engaged only in business-type activities. Accordingly, the Institute's financial statements have been presented using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis, revenues are recognized when earned,

and expenses are recorded when an obligation has been incurred. All significant intra-agency transactions have been eliminated.

D. Investments

In accordance with GASB Statement 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, purchased investments, interest-bearing temporary investments classified with cash, and investments received as gifts are recorded at fair value. All investment income, including changes in the fair value of investments (unrealized gains and losses), is reported as non-operating revenue in the Statement of Revenues, Expenses, and Changes in Net Assets.

E. Capital Assets

Capital assets include land, buildings and other improvements, library materials, equipment and infrastructure assets such as sidewalks, steam tunnels, and electrical and computer network cabling systems. Capital assets are generally defined by the Institute as assets with an initial cost of \$5,000 or more and an estimated useful life in excess of two years. Buildings and equipment are stated at appraised value or actual cost where determinable. Land is stated at cost. Library materials are valued using published average prices for library acquisitions. Expenses for major capital assets and improvements are capitalized (construction in progress) as projects are constructed. Operating expenditures of \$10,000 or greater for renewals and replacement are capitalized only to the extent that such expenditures represent long-term improvement to properties. Interest expense relating to construction is capitalized net of interest income earned on resources set aside for this purpose. The costs of normal maintenance and repairs that do not add to an asset's value or materially extend its useful life are not capitalized.

Depreciation is computed using the straight-line method over the estimated useful life of the asset. Useful lives by asset categories are listed below:

Buildings	50 years
Other improvements	10-30 years
Equipment	5-25 years
Library materials	10 years

F. Inventories

Inventories are valued at cost using the first-in, first-out method.

G. Unearned Revenue

Unearned revenue represents revenues collected but not earned as of June 30, 2007. This is primarily composed of revenue for student tuition and fees received in advance of the next semester or term.

H. Interest Capitalization

Interest expense incurred during the construction of capital assets is capitalized, if material, net of interest income earned on resources set aside for this purpose. The Institute incurred net interest expense totaling \$710,336 for the fiscal year ended June 30, 2007. Interest capitalized for the fiscal year ended June 30, 2007, totaled \$369,166.

I. Accrued Compensated Absences

Non-faculty salaried employee's attendance and leave regulations make provisions for the granting of a specified number of days of leave with pay each year. Instructional personnel do not earn leave. The amount of leave earned but not taken as of June 30, 2007 is recorded as a liability on the Statement of Net Assets. The liability reflects all earned vacation, compensatory and overtime leave not taken as well as the amount payable under the Commonwealth of Virginia's sick leave payout policy upon termination which is the lesser of 25 percent of sick leave not taken or \$5,000 per employee with five or more years of service. Also included is an estimation of sick leave for those employees who, while not currently vested, will probably attain the five years of service required to vest. The last element reflected in the liability is payroll taxes to be paid by the Institute on all accrued compensated absences.

J. Federal Financial Assistance Programs

The Institute participates in federally funded Pell Grants, Supplemental Educational Opportunity Grants, Federal Work-Study and Perkins Loans programs. Federal programs are audited in accordance with the Single Audit Act Amendments of 1996, the Office of Management and Budget Revised Circular A-133, *Audit of States, Local Governments and Non-Profit Organizations*, and the Compliance Supplement.

K. Net Assets

GASB Statement 34 requires that the Statement of Net Assets report the difference between assets and liabilities as net assets, not fund balances.

The Institute's net assets are classified as follows:

Invested in capital assets, net of related debt: This represents the Institute's total investment in capital assets, net of outstanding debt obligations related to those capital assets. To the extent debt has been incurred but not yet expended for capital assets, such amounts are not included as a component of invested in capital assets, net of related debt.

Restricted net assets – nonexpendable: Nonexpendable restricted net assets consist of endowment funds in which donors or other outside sources have stipulated, as a condition of the gift instrument, that the principal is to be maintained inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may either be expended or added to the principal.

Restricted net assets – expendable: Restricted expendable net assets include resources in which the Institute is legally or contractually obligated to spend in accordance with restrictions imposed by external third parties.

Unrestricted net assets: Unrestricted net assets represent resources derived from student tuition and fees, state appropriations, and sales and services of educational departments and auxiliary enterprises. These resources are used for transactions relating to the educational and general operations of the Institute, and may be used at the discretion of the governing board to meet current expenses for any purpose. These resources also include auxiliary enterprises, which are substantially self-supporting activities that provide services for students, faculty and staff. Also included in unrestricted net assets are funds that have been set aside by the Board of Visitors as quasi-endowments. These funds are treated the same as true endowment funds; however, unlike true endowments they may be expended.

The Institute has no policy regarding flow assumption to determine which assets (restricted or unrestricted) are being used when both restricted and unrestricted assets are available for the same purpose. Our practice is to allow department heads to make this determination and they typically spend unrestricted assets prior to spending restricted resources.

L. Classification of Revenues

The Institute has classified its revenues as either operating or non-operating revenues according to the following criteria:

Operating revenues: Operating revenues include activities that have the characteristics of exchange transactions, such as (1) student tuition and fees, net of scholarship discounts and allowances, (2) sales and services of auxiliary enterprises, net of scholarship discounts and allowances, (3) most federal, state and local grants and contracts, and (4) interest on student loans.

Nonoperating revenues: Nonoperating revenues include activities that have the characteristics of nonexchange transactions, such as gifts and contributions, and other revenue sources that are defined as non-operating revenues by GASB Statement 9 *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, GASB Statement 33 *Accounting and Financial Reporting for Non-exchange Transactions*, and GASB Statement 34, such as state appropriations and investment income.

Scholarship Discounts and Allowances: Student tuition and fee revenues are reported net of scholarship discounts and allowances in the statements of revenues, expenses, and changes in net assets. Scholarship discounts and allowances are the difference between the stated charge for goods and services provided by the Institute, and the amount that is paid by students and/or third parties making payments on the students' behalf. Certain governmental grants, such as Pell grants, and other federal, state or nongovernmental programs, are recorded as either operating or non-operating revenues in the Institute's financial statements. To the extent that revenues from

such programs are used to satisfy tuition and fees, the Institute has recorded a scholarship discount and allowance.

M. Reclassification

Certain amounts from the prior fiscal year have been reclassified to conform to Virginia Department of Treasury reporting guideline changes for the VCBA 21st Century program and General Obligation bond reimbursement programs. The following adjustment has been made to the ending net asset balance of fiscal year 2006.

Net assets reported at June 30, 2006	\$128,785,738
Reporting change Virginia Department of Treasury	<u>(1,894,700)</u>
Beginning net assets, at June 30, 2006, as adjusted	<u>\$126,891,038</u>

2. CASH AND CASH EQUIVALENTS AND INVESTMENTS

The following information is provided with respect to the Institute's cash, cash equivalents, and investments as of June 30, 2007. The following risk disclosures are required by GASB Statement 40, *Deposit and Investment Risk Disclosures*.

Custodial credit risk (Category 3 deposits and investments) – The custodial risk for deposits is the risk that, in the event of a failure of a depository financial institution, a government will not be able to recover deposits or will not be able to recover collateral securities that are in the possession of an outside party. The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of investment or collateral securities that are in possession of an outside party. The Institute had no category 3 deposits or investment for fiscal year 2007.

Credit risk – The risk that an issuer or other counterparty to an investment will not fulfill its obligations. GASB Statement 40 requires the disclosure of the credit quality ratings of all investments subject to credit risk.

Concentration of credit risk – The risk of loss attributed to the magnitude of a government's investment in a single issuer is referred to as a credit risk. GASB Statement 40 requires disclosure of any issuer with more than five percent of total investments.

Interest rate risk - This is the risk that interest rate changes will adversely affect the fair value of an investment. GASB Statement 40 requires disclosure of maturities for any investments subject to interest rate risk. The Institute does not have an interest rate risk policy.

Foreign currency risk – This risk refers to the possibility that changes in exchange rates will adversely affect the fair value of an investment or a deposit.

The Institute's credit risk, concentration of credit risk, interest rate risk, and foreign currency risk are described in the Investments Note below.

Cash and Cash Equivalents

Pursuant to Section 2.2-1800, et seq., Code of Virginia, all state funds of VMI are maintained by the Treasurer of Virginia, who is responsible for the collection, disbursement, custody, and investment of state funds. Cash deposits held by VMI are maintained in accounts that are collateralized in accordance with the Virginia Security for Public Deposits Act, Section 2.2-4400, et seq., Code of Virginia. In accordance with the GASB Statement 9 *Definition of Cash and Cash Equivalents*, cash represents cash with the Treasurer, cash on hand, and cash deposits including certificate of deposits, and temporary investments with original maturities of three months or less.

Cash and cash equivalents consist of the following balances as of June 30, 2007:

Cash with Treasurer of Virginia	\$69,867,672
SunTrust NOW checking	3,571,361
State Non-Arbitrage Program (SNAP)*	2,832
Bank of New York Bond Fund	
Interest	778
Securities under securities lending	241,640
Petty cash	10,070
Wachovia Bank time deposit	<u>28,000</u>
Total cash and cash equivalents	<u>\$73,722,353</u>

*Rated as 'AAAm' by Standard and Poor

Investments

Investments include endowment and similar funds pooled and invested with VMI affiliates and retirement fund investments for selected employees. It also includes VMI's allocated share of securities held for security lending transactions conducted by the Commonwealth. Investments consist of the following balances as of June 30, 2007:

Investments with the Treasurer of Virginia:	
Securities under securities lending	\$ 951,956
Investments with trustees:	
Investments pooled with VMI Affiliates	20,152,971
Mutual fund investments (retirement accounts)	<u>602,925</u>
Total with trustees	<u>20,755,896</u>
Total investments	<u>\$21,707,852</u>

VMI's endowment, loan, and similar funds are pooled for investment purposes with the endowment funds of the VMI Alumni Agencies (the VMI Foundation, Inc., the VMI Development Board, Inc., the VMI Keydet Club, and the VMI Alumni Association) and the George C. Marshall Foundation. VMI owns units in the pooled fund that operates similar to a mutual fund. The Board of Trustees of the VMI Foundation, Inc. is responsible for the management of these endowment funds (the Fund) and has appointed an Investment Committee to supervise the Fund's assets. The Committee is responsible for setting and implementing the investment policies and guidelines

adopted by the Committee. Authorized investments are set forth in the Uniform Management of Institutional Funds Act, Section 55-268 et seq. of the Code of Virginia and include cash equivalents, preferred and common stocks, bonds, and real estate.

The market value of the Fund as of June 30, 2007 was \$362.3 million, of which, VMI owned \$20.2 million or 5.6 percent of the Fund assets. The Fund held \$46.2 million in debt securities with an average maturity of 7.09 years. The average quality rating was Aaa (Moody's). Bonds must be rated above investment grade by two of the following rating agencies: Moody's, Fitch Rating, and Standard and Poor's at the time of purchase and cannot be more than 20 percent of the total assets invested in bonds (at market). No stock may be in excess of five percent of the equity portfolio at cost or ten percent at market. No more than 25 percent of the equity portfolio at market value may be invested in any one general industry as defined by the S&P 500 industry classifications. No more than three percent of the outstanding shares of any company may be owned in the equity portfolio. The Fund held \$82.3 million in international equities denominated primarily in the Euro, the Pound, and the Yen. The custodians for the Fund are independently audited annually.

Securities Lending Transactions

Collateral held for securities lending and the securities lending transactions reported on the financial statements represent the Institute's allocated share of securities received for securities lending transactions held in the General Account of the Commonwealth. Information related to the credit risk of these investments and securities lending transactions held in the General Account is available on a statewide level in the Commonwealth of Virginia's *Comprehensive Annual Financial Report*.

Funds Held In Trust By Others

Assets of funds held by trustees for the benefit of the Institute are not reflected in the accompanying Statement of Net Assets. The Institute has irrevocable rights to all or a portion of the income of these funds. However, assets of the funds are not under the management discretion of the Institute according to the trust agreements. Income from funds held by trustees for the benefit of the Institute totaled \$60,727 for the year ended June 30, 2007, and is included in the endowment income.

3. ACCOUNTS RECEIVABLE

Accounts receivable consisted of the following at June 30, 2007:

Student tuition and fees	\$240,640
Other educational and general	39,916
Auxiliary enterprises	95,009
Unique military activity	4,126
Federal grants	24,123
State grants	725
Agency funds	240,591
Other operating	131,867
Retirement of indebtedness	<u>86,216</u>
Total	863,213
Less: Allowance for doubtful accounts	<u>(55,679)</u>
Net accounts receivable	<u>\$807,534</u>

4. INVENTORIES

Inventories consisted of the following at June 30, 2007:

Physical Plant	\$ 374,682
Military Store	3,491,892
Museums	110,513
VMI Hospital	<u>13,664</u>
Total	<u>\$3,990,751</u>

5. CAPITAL ASSETS

A summary of changes in the various capital asset categories is presented as follows:

	Beginning Balance July 1, 2006	Additions	Reductions	Ending Balance June 30, 2007
Non-depreciable capital assets:				
Land	\$ 1,919,630	\$ 16,090	\$ -	\$ 1,935,720
Construction in progress	<u>57,101,302</u>	<u>22,220,216</u>	<u>(43,344,432)</u>	<u>35,977,086</u>
Total non-depreciable capital assets	<u>59,020,932</u>	<u>22,236,306</u>	<u>(43,344,432)</u>	<u>37,912,806</u>
Depreciable capital assets:				
Buildings	93,850,944	55,507,069	(2,815,642)	146,542,371
Improvements other than buildings	3,050,132	8,671,124	(220,138)	11,501,118
Equipment	11,007,544	1,887,023	(434,216)	12,460,351
Library books	<u>10,396,369</u>	<u>253,883</u>	<u>(86,362)</u>	<u>10,563,890</u>
Total depreciable capital assets	<u>118,304,989</u>	<u>66,319,099</u>	<u>(3,556,358)</u>	<u>181,067,730</u>
Less accumulated depreciation for:				
Buildings	50,250,230	2,608,079	(2,030,809)	50,827,500
Improvements other than buildings	1,694,001	396,998	(131,135)	1,959,864
Equipment	6,325,557	1,127,774	(412,631)	7,040,700
Library books	<u>8,836,968</u>	<u>226,569</u>	<u>(86,362)</u>	<u>8,977,175</u>
Total accumulated depreciation	67,106,756	4,359,420	(2,660,937)	68,805,239
Depreciable capital assets	<u>51,198,233</u>	<u>61,959,679</u>	<u>(895,421)</u>	<u>112,262,491</u>
Total capital assets, net	<u>\$110,219,165</u>	<u>\$84,195,985</u>	<u>\$(44,239,853)</u>	<u>\$150,175,297</u>

6. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Accounts payable and accrued expenses consisted of the following at June 30, 2007:

Current liabilities:	
Employee salaries, wages and benefits payable	\$3,125,220
Vendors and supplies accounts payable	3,544,070
Accrued interest payable	117,541
Other accrued liabilities	<u>23,341</u>
Total current-accounts payable and accrued liabilities	<u>\$6,810,172</u>
Non-current liabilities:	
Accrued liabilities:	
Retirement annuities	\$602,926
Other	<u>30,000</u>
Total non-current-accrued liabilities	<u>\$632,926</u>

7. NON-CURRENT LIABILITIES

The Institute's long-term liabilities primarily consist of long-term debt (further described in Note 8) and accrued compensated absences. A summary of changes in long-term liabilities for the year ending June 30, 2007 is presented as follows:

	Beginning Balance July 1, 2006	Additions	Reductions	Ending Balance June 30, 2007	Current Portion June 30, 2007
Long-term debt:					
Bonds payable	\$11,474,632	\$ -	\$ (392,479)	\$11,082,153	\$ 380,000
Notes payable	5,097,302	-	(437,644)	4,659,658	440,000
Capital leases	-	30,413	(4,682)	25,731	5,527
Installment purchases	<u>138,382</u>	<u>-</u>	<u>(31,973)</u>	<u>106,409</u>	<u>31,973</u>
Total long-term debt	16,710,316	30,413	(866,778)	15,873,951	857,500
Accrued compensated absences	<u>1,270,656</u>	<u>988,886</u>	<u>(904,060)</u>	<u>1,355,482</u>	<u>864,708</u>
Total long-term liabilities	<u>\$17,980,972</u>	<u>\$1,019,299</u>	<u>\$(1,770,838)</u>	<u>\$17,229,433</u>	<u>\$1,722,208</u>

8. LONG-TERM INDEBTEDNESS

Bonds payable

In August 2004, pursuant to Section 9(c) of Article X of the Constitution of Virginia, \$11,240,000 of revenue bonds, Series 2004A, were issued by the Department of Treasury for the Commonwealth of Virginia, on behalf of the Institute for renovation and expansion of Crozet Hall, the Institute dining facility, and parking. The bonds bear interest at an average coupon rate of 4.8 percent and are payable over 20 years through June 2025. Net proceeds after the cost of issuance total \$11,889,591 and included a premium realized on the sale. The revenue bonds are secured by the net revenues of the facility which is comprised primarily of cadet fees.

	Interest Rates (%)	Maturity	Balance June 30, 2007
Bonds Payable:			
Crozet Hall, Series 2004A	4.63 - 5.00	2025	<u>\$11,082,153</u>

Notes payable

Notes payable are debt obligations between the Virginia College Building Authority (VCBA) and the Institute. The VCBA issues bonds through the Pooled Bond Program and uses the proceeds to purchase debt obligations (notes) of the Institute. The Barracks Wiring and JM Hall Renovation notes are secured by funds paid by the VMI Foundation, Inc. on a year-to-year basis as a gift to the Institute. Should the gift be discontinued, repayment will be made from the general revenues of the Institute. The Cocke Hall Annex note will be paid from auxiliary reserve funds which consist predominantly of cadet fees.

	<u>Interest Rates (%)</u>	<u>Maturity</u>	<u>Balance June 30, 2007</u>
- Notes Payable:			
Barracks Wiring, Series 1998A	3.70 - 4.10	2009	\$ 560,000
Cocke Hall Annex, Series 2002A	4.00 - 5.25	2022	1,903,138
JM Hall Renovation, Series 2002A	4.00 - 5.25	2022	<u>2,196,520</u>
Total			<u>\$4,659,658</u>

Maturities on notes and bonds payable for years succeeding June 30, 2007 are as follows:

	<u>Bond Payable</u>	<u>Notes Payable</u>	<u>Total</u>
2008	\$ 380,000	\$ 440,000	\$ 820,000
2009	400,000	460,000	860,000
2010	415,000	180,000	595,000
2011	440,000	190,000	630,000
2012	455,000	200,000	655,000
2013-2017	2,635,000	1,165,000	3,800,000
2018-2022	3,365,000	1,495,000	4,860,000
2023-2025	2,440,000	340,000	2,780,000
Plus: Unamortized premium	<u>552,153</u>	<u>189,658</u>	<u>741,811</u>
Total future principal requirements	<u>\$11,082,153</u>	<u>\$4,659,658</u>	<u>\$15,741,811</u>

Interest commitments for the year succeeding June 30, 2007 are as follows:

	<u>Bonds Payable</u>	<u>Notes Payable</u>	<u>Total</u>
2008	\$ 509,856	\$ 215,535	\$ 725,391
2009	490,856	195,692	686,548
2010	470,856	180,975	651,831
2011	450,106	171,725	621,831
2012	433,606	161,975	595,581
2013-2017	1,804,031	640,894	2,444,925
2018-2022	1,075,282	293,606	1,368,888
2023-2025	<u>225,694</u>	<u>8,925</u>	<u>234,619</u>
Total future interest requirements	<u>\$5,460,287</u>	<u>\$1,869,327</u>	<u>\$7,329,614</u>

Installment Purchase Obligations

The Institute has future obligations under installment purchase agreements. The book value of the assets capitalized under these installment purchase agreements is \$157,669 with no interest. A summary of future obligations under these agreements as of June 30, 2007 follows:

<u>Year Ending</u> <u>June 30, 2007</u>	<u>Principal</u>
2008	\$ 31,973
2009	31,973
2010	29,774
2011	<u>12,689</u>
Total	<u>\$106,409</u>

Capital Leases Payable

VMI is the lessee of equipment under capital leases expiring in 2012. The assets acquired under capital leases are recorded as property, plant, and equipment at the lower of the net present value of the minimum lease payments during the lease term or the fair market value of the asset.

For all capital leases, the minimum lease payments together with the present value of the net minimum lease payments as of June 30, 2007 are as follows.

<u>Year ending</u> <u>June 30,</u>	<u>Amount</u>
2008	\$ 9,925
2009	9,925
2010	9,925
2011	9,925
2012	<u>827</u>
Total Minimum lease payments	40,527
Less: Executory costs	(10,132)
Interest	<u>(4,664)</u>
Present value of net minimum lease payments	<u>\$25,731</u>

Equipment Trust Fund

The Equipment Trust Fund (ETF) program was established to provide state-supported institutions of higher education bond proceeds for financing the acquisition and replacement of instructional and research equipment. The Virginia College Building Authority (VCBA) manages the program. The VCBA issues bonds and uses the proceeds to reimburse the Institute and other institutions of higher education for equipment purchased. For fiscal years prior to 1999, the VCBA purchased the equipment and leased it to the Institute. For fiscal years 1999 and following, financing agreements for ETF were changed so that the Institute now owns the equipment from the date of purchase.

The Statement of Net Assets line "Due from the Commonwealth of Virginia" includes \$26,057 representing equipment purchased by the Institute that was not reimbursed by the VCBA as of June 30, 2007.

Operating Leases

VMI is committed under various operating leases for equipment. Operating leases do not give rise to property rights or lease obligations, and therefore the results of the lease agreements are not reflected in the Institute's Statement of Net Assets. In general, the leases are for a three year term and the Institute has renewal options. In most cases, the Institute expects these leases will be replaced by similar leases in the normal course of business. Rental expense was approximately \$94,054 for the year ended June 30, 2007. Rental expense commitments for subsequent fiscal years are as follows:

Year ending <u>June 30,</u>	<u>Amount</u>
2008	\$ 79,452
2009	47,040
2010	21,674
2011	18,662
2012	<u>5,169</u>
Total	<u>\$171,997</u>

Capital Improvement Commitments

As of June 30, 2007, the Institute had outstanding construction contract commitments of \$42,083,405. This amount represents the value of obligations remaining on capital improvement project contracts. These obligations are for future efforts and as such have not been accrued as expenses or liabilities on the Institute's financial statements.

9. RETAINAGE PAYABLE

At June 30, 2007, \$1,278,312 was held by the Institute as retainage on various contracts for work, which had been performed. The retainage will be remitted to the various contractors upon satisfactory completion of the projects.

10. EXPENSES BY NATURAL CLASSIFICATIONS

The Institute's operating expenses by natural classification were as follows for the year ended June 30, 2007.

Program	Personal Services	Supplies	Contractual Services	Equipment	Utilities	Student Aid	Other	Depreciation	Total
Instruction	\$13,818,339	\$ 160,179	\$ 512,397	\$ 457,268	\$ -	\$ -	\$ 34,231	\$1,338,639	\$16,321,053
Research	198,728	26,371	94,396	-	-	-	15,393	37,527	372,415
Public service	606,130	229,404	358,005	8,634	-	-	21,008	109,377	1,332,558
Academic support	3,519,230	92,463	1,005,759	84,318	-	-	177,803	616,637	5,496,210
Student services	1,839,992	103,981	788,743	73,478	-	-	90,807	215,837	3,112,838
Institutional support	3,073,881	192,481	919,205	73,783	2,687	-	277,372	114,542	4,653,951
Operation and maintenance of plant	2,373,080	952,475	889,435	287,537	647,753	-	236,326	357,861	5,744,467
Student aid	3,174	1,972	22,593	-	-	751,146	-	-	778,885
Auxiliary enterprises	4,731,391	439,677	6,149,935	579,847	219,583	132,000	3,195,987	1,309,067	16,757,487
Unique military activities	3,440,304	689,436	58,909	42,927	-	-	349,316	259,932	4,840,824
Loan cancellation costs	-	-	-	-	-	-	17,245	-	17,245
Total operating expenses	<u>\$33,604,249</u>	<u>\$2,888,439</u>	<u>\$10,799,377</u>	<u>\$1,607,792</u>	<u>\$870,023</u>	<u>\$883,146</u>	<u>\$4,415,488</u>	<u>\$4,359,419</u>	<u>\$59,427,933</u>

11. STATE APPROPRIATIONS

The Institute receives state appropriations from the General Fund of the Commonwealth of Virginia. The Appropriation Act specifies that such unexpended appropriations shall revert, as specifically provided by the General Assembly, at the end of the biennium. For years ending at the middle of the biennium, unexpended appropriations that have not been approved for reappropriation in the next year by the Governor become part of the General Fund of the Commonwealth and are, therefore, no longer available to the Institute for disbursement. Fiscal year 2008 ends the biennium.

During the fiscal year ended June 30, 2007, the Institute received the following supplemental appropriations and reversions in accordance with the Appropriation Act:

Original legislative appropriation:	
Educational and general programs	\$10,283,440
Unique military activity	4,382,037
Student financial assistance	691,620
Adjustments:	
Compensation adjustments	275,405
ETF lease payment - NGF portion	(88,844)
Debt service fee	(36,135)
June 30, 2006 payroll-general fund (25th pay)	(452,602)
Appropriations transfers:	
Authorized fiscal year 08 Transfer-E&G	(34,000)
SCHEV programs	25,672
Virginia Tech	<u>(1,480,824)</u>
Adjusted appropriations	<u>\$13,565,769</u>

12. RETIREMENT AND PENSION SYSTEMS

Employees of the Institute are employees of the Commonwealth of Virginia. Most full-time classified salaried employees of the Institute participate in the defined benefit retirement plan administered by the Virginia Retirement System (VRS). The Institute Post Police officers participate in the Virginia Law Officers Retirement System, (VaLORS), instead of VRS. Both VRS and VaLORS are agent multiple-employer public employee retirement systems (PERS) that acts as a common investment and administrative agency for the Commonwealth of Virginia and its political subdivisions.

The Institute's payroll costs for employees covered by VRS totaled \$12,908,210 for the year ended June 30, 2007. The Institute's total payroll costs were \$25,840,844 for the year ended June 30, 2007.

Information regarding types of employees covered, benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions as well as employer and employee obligations to contribute are established, can be found in the Commonwealth's Comprehensive Annual Financial Report (CAFR).

The Institute's total VRS contribution was \$1,616,108 for the year ended June 30, 2007, which included the five percent employee contribution assumed by the employer. These contributions represent 12.52 percent of covered payrolls for 2007.

The Institute's payroll cost for employees covered by VaLORS was \$253,791 for the year ended June 30, 2007. The Institute's total VaLORS contribution was \$55,174 for the year ended June 30, 2007, which represents 21.74 percent of the covered payroll for the 2007 fiscal year.

The VRS does not measure assets and pension benefit obligations separately for individual state institutions. The CAFR provides disclosure of the Commonwealth's unfunded pension benefit

obligation at June 30, 2007. The same report contains historical trend information showing VRS's progress in accumulating sufficient assets to pay benefits when due.

TIAA/CREF Insurance Company

Some full-time faculty and contracted administrative staff participate in a retirement annuity program through TIAA/CREF Insurance Companies rather than the VRS. This is a fixed-contribution program where the retirement benefits received are based entirely upon the employer's (10.4 percent) contributions, plus interest and dividends, with the employer assuming the employee's contribution share.

Individual contracts issued under the plan provide for full and immediate vesting of both the Institute's and the employees' contributions. Total pension costs under this plan were approximately \$782,930 year ended June 30, 2007. Contributions to the TIAA/CREF Insurance Companies were calculated using the base salary amount of approximately \$7,528,177 for fiscal year 2007.

Fidelity Investments

The Institute also contributed to one other defined contribution pension plan, which is insignificant in relation to VRS and TIAA/CREF. Full-time faculty, certain administrative staff that hold academic rank and athletic coaches are eligible to participate in this program other than VRS and TIAA/CREF. Retirement benefits received are based entirely upon the employer's (10.4 percent) contributions, plus interest and dividends, with the employer assuming the employee's contribution share.

Amounts contributed to Fidelity Investments were calculated using the base salary amount of approximately \$1,004,462 for fiscal year ended June 30, 2007. Total pension costs under this plan were approximately \$104,464 for fiscal year 2007.

Deferred Compensation Plan

Employees of the Commonwealth may participate in the Commonwealth's Deferred Compensation Plan. Participating employees can contribute to the plan each pay period with the Commonwealth matching up to \$20 per pay period. The dollar amount match can change depending on the funding available in the Commonwealth's budget. The Deferred Compensation Plan is a qualified defined contribution plan under Section 401(a) of the Internal Revenue Code. Employer contributions under the Deferred Compensation Plan were approximately \$97,090 for the fiscal year 2007.

13. POST-EMPLOYMENT BENEFITS

The Commonwealth participates in the VRS administered statewide group life insurance program which provides postemployment life insurance benefits to eligible retired and terminated employees. The Commonwealth also provides health care credits against the monthly health insurance premiums of its retirees who have at least 15 years of service and participate in the State's health plan. Information related to these plans is available at the statewide level in the Commonwealth's Comprehensive Annual Financial Report.

14. RISK MANAGEMENT

The Institute is exposed to various risks of loss related to torts; theft or, damage to, and destruction of assets; errors and omissions; non-performance of duty; injuries to employees; and natural disasters. The Institute participates in insurance plans maintained by the Commonwealth of Virginia. The state employee health care and worker's compensation plans are administered by the Department of Human Resource Management and the risk management insurance plans are administered by the Department of Treasury, Division of Risk Management. Risk management insurance includes property, general liability, medical malpractice, faithful performance of duty bond, automobile, and air and watercraft plans. The Institute pays premiums to each of these Departments for its insurance coverage. Information relating to the Commonwealth's insurance plans is available at the statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

15. CONTINGENCIES

The Institute has received federal grants for specific purposes that are subject to review and audit by the grantor agencies. Claims against these resources are generally conditional upon compliance with the terms and conditions of grant agreements and applicable federal regulations, including the expenditure of resources for allowable purposes. Any disallowance resulting from a federal audit may become a liability of the Institute.

In addition, the Institute is required to comply with various federal regulations issued by the Office of Management and Budget. Failure to comply with certain systems requirements of these regulations may result in questions concerning the allowability of related direct and indirect charges pursuant to such agreements. As of June 30, 2007, the Institute estimates that no material liabilities will result from such audits or questions.

In October 2003, VMI entered into a contract modification with Aramark Educational Services, VMI's contracted dining services vendor. Under this agreement, Aramark provided \$1,200,000 to VMI to support the expansion and renovation of the Crozet Hall dining facility. The agreement requires Aramark to amortize this cost on a straight-line basis over a ten-year period. In the event that VMI or Aramark terminates the contract, VMI must re-pay any unamortized balance to Aramark within 90 days of termination.

16. LITIGATION

The renovation of Crozet Hall Project was substantially completed on July 27, 2006, 270 days after the original contracted completion date. On May 23, 2007, the contractor filed a claim in Rockbridge County Court, suing the Institute for damages in the amount of \$430,242 as a result of these delays. On July 26, 2007, the Institute paid the contractor \$99,646, the amount to which the Institute believes the contractor is entitled, leaving an outstanding claim against the Institute of \$330,596. The Institute is contesting the claim.

17. VMI ALUMNI AGENCIES

The VMI Alumni Agencies (the Agencies) are comprised of four organizations that share the common purpose of raising funds, investing funds, and performing other activities on behalf of VMI alumni and other donors in support of Virginia Military Institute (VMI). Significant sources of revenue consist of contributions and investment return. Due to their shared purpose, the Agencies have elected to present their financial statements on a combined basis. All significant interagency

accounts and transactions have been eliminated in combination. The individual organizations comprising the Agencies and their purposes are as follows:

- The VMI Alumni Association

The purpose of The VMI Alumni Association is to organize the alumni of VMI into one general body.

- VMI Foundation, Incorporated

The purposes of the VMI Foundation, Incorporated are to solicit and to accept various funds and to disburse such funds, or income earned from those funds, for the advancement of VMI and the Alumni Association.

- VMI Development Board, Incorporated

The purposes of the VMI Development Board, Incorporated are to support VMI by coordinating development and fundraising efforts conducted on behalf of VMI Alumni and other donors.

- VMI Keydet Club, Incorporated

The purposes of the VMI Keydet Club, Incorporated are to support, strengthen, and develop the intercollegiate athletic program at VMI.

Contributions receivable

Contributions receivable consist of the following:

Unconditional promises to give	\$16,983,119
Charitable trust held by others	<u>212,893</u>
Net contributions receivable	17,196,012
Less: current portion	<u>(6,206,271)</u>
Non-current contributions receivable	<u>\$10,989,741</u>
Gross amounts expected to be collected in:	
Less than one year	\$ 6,895,858
One to five years	10,564,312
More than five years	<u>4,227,960</u>
Gross contributions receivable	21,688,130
Less:	
Discount net present value at three percent – six percent	(2,344,594)
Allowance for uncollectible contributions	<u>(2,147,524)</u>
Net contributions receivable	<u>\$17,196,012</u>

The ownership of contributions receivable for each class of net assets as of June 30, 2007 is as follows:

Temporarily restricted	\$15,465,439
Permanently restricted	<u>1,730,573</u>
Net contributions receivable	<u>\$17,196,012</u>

At June 30, 2007, the Agencies had also received bequest and other intentions of approximately \$88.5 million. These intentions to give are not recognized as assets and, if they are received, they will generally be restricted for specific purposes stipulated by the donors.

For the year ended June 30, 2007 approximately 19 percent of the contributions receivable balance was from two donors.

Investments held by trustees

The Agencies participate in a combined investment fund (the "Fund") controlled by the VMI Investment Committee, a committee comprised of representatives from each agency. Mellon Trust of Boston, N.A. serves as custodian for the Fund's assets. The Fund's investments consist of the following:

Equities	\$282,971,191	84.1%
Fixed income bond	42,074,680	12.5%
Cash and cash equivalents	<u>11,456,139</u>	<u>3.4%</u>
Total	336,502,010	<u>100.0%</u>
Less: Amount payable for securities purchased, net	<u>(3,109,587)</u>	
Investments held by trustees	<u>\$333,392,423</u>	

These investments, which comprise the majority of the Agencies' assets, are subject to market risk. However, the Agencies' investment funds are managed by a number of investment managers, which limits the amount of risk in any one fund. The Agencies' Investment Committee establishes investment guidelines and performance standards which further reduce its exposure to market risk.

Investments held by trustees activity is reflected in the table below:

Investments, beginning	<u>\$282,577,602</u>
Investments returns:	
Dividends and interest	6,110,507
Net realized and unrealized gains	45,610,458
Less: investment fees	<u>(1,706,511)</u>
	<u>50,014,454</u>
Net receipts from Mellon account used to fund operations	<u>800,367</u>
Investment, ending	<u>\$333,392,423</u>

The Agencies employ a total return spending policy that establishes the amount of investment return that is available to support current needs and restricted purposes. This policy is designed to insulate program spending from capital market fluctuations and increase the amount of return that is reinvested in the corpus of the fund in order to enhance its long-term value. For the year ended June 30, 2007, the Board-approved spending formula for the endowment provided for an annual spending rate of not more than 5.0 percent of the average of the prior twelve quarters' December 31 market values adjusting these market values upward to reflect subsequent receipt of gifts, or downward to reflect extraordinary withdrawals. If cash yield (interest and dividends) is less than the spending rate, realized gains can be used to make up the deficiency. Any income in excess of the spending rate is to be reinvested in the endowment.

Investments, Other

Investments, other, consist of the following:

	Held by Agent	Held by Foundation	Held in Irrevocable Trusts*	Total at Fair Value**
Equities	\$1,934,464	\$ 10	\$ 9,672,195	\$11,606,669
Fixed income	47,545	5,891	4,798,427	4,851,863
Real estate	-	1,975,667	-	1,975,667
Cash and cash equivalents	54,172	800	309,354	364,326
Limited partnerships	<u>151</u>	<u>17,128</u>	<u>-</u>	<u>17,279</u>
Total	<u>\$2,036,332</u>	<u>\$1,999,496</u>	<u>\$14,779,976</u>	<u>\$18,815,804</u>

*Investments held in irrevocable trusts are not available for use until the occurrence of a future event as noted in the applicable trust agreements.

**For certain components of these investments, primarily real estate, limited partnerships, and common stocks of closely held companies, where fair values were not readily determinable, cost was used.

Bonds Payable

Bonds payable consists of the following:

Variable Rate Educational Facilities Revenue Bonds, Series 2006, payable in varying installments from \$1,080,000 to \$2,770,000, commencing 2012 through 2036. Interest payments commenced August 2006; rate is variable and ranged from 3.47 percent to 4.02 percent during the year ended June 30, 2007. Interest is subject to an interest rate swap agreement which requires a fixed rate payment by the Agencies of 3.92780 percent on \$30,000,000 of the debt. Collateralized by a \$45.4 million letter of credit. Unexpended proceeds at June 30, 2007 are included in funds restricted for affiliate in the combined statement of financial position.	\$45,000,000
Mark-to-market estimate of bank swap transaction related to Industrial Development Authority Bonds	<u>187,836</u>
Long-term bonds payable	<u>\$45,187,836</u>

Debt matures as follows:

<u>Year ending</u>	
2012	\$ 1,080,000
2013 and later years	43,920,000
Mark-to-market on interest rate swap	<u>187,836</u>
	<u>\$45,187,836</u>

The Agencies entered into an interest rate swap agreement in May 2006. The swap agreement has a notational amount of \$30,000,000 that effectively converts the variable rate based payments on \$30,000,000 of bond debt to a fixed rate interest payment at 3.92780 percent. This swap was effective beginning August 1, 2006 and expires August 1, 2013.

18. COMPONENT UNITS

Condensed financial statements for the component units of the Institute are as follows:

Condensed Statement of Net Assets As of June, 30 2007	VMI Research Laboratories Inc.	VMI Alumni Agencies	Total
Assets:			
Current assets	\$ 335,043	\$ 20,326,154	\$ 20,661,197
Noncurrent assets	<u>118,477</u>	<u>380,770,050</u>	<u>380,888,527</u>
Total assets	<u>\$ 453,520</u>	<u>\$401,096,204</u>	<u>\$401,549,724</u>
Liabilities:			
Current liabilities	\$ 145,914	\$ 1,330,370	\$ 1,476,284
Noncurrent liabilities	<u>16,475</u>	<u>51,073,320</u>	<u>51,089,795</u>
Total liabilities	<u>162,389</u>	<u>52,403,690</u>	<u>52,566,079</u>
Net assets:			
Unrestricted	212,595	51,135,591	51,348,186
Temporarily restricted	68,536	197,568,547	197,637,083
Permanently restricted	<u>10,000</u>	<u>99,988,376</u>	<u>99,998,376</u>
Total net assets and liabilities	<u>\$453,520</u>	<u>\$401,096,204</u>	<u>\$401,549,724</u>
	VMI Research Laboratories Inc.	VMI Alumni Agencies	Total
Condensed Statement of Activities For the year ended June, 30 2007			
Total revenues	\$ 686,682	\$ 24,266,379	\$ 24,953,061
Total expenses	(865,870)	(44,164,323)	(45,030,193)
Total net realized and unrealized gains on investments	<u>-</u>	<u>47,555,970</u>	<u>47,555,970</u>
Total change in net assets	(179,188)	27,658,026	27,478,838
Total beginning net assets	<u>470,319</u>	<u>321,034,488</u>	<u>321,504,807</u>
Total ending net assets	<u>\$291,131</u>	<u>\$348,692,514</u>	<u>\$348,983,645</u>

19. SUBSEQUENT EVENTS

On October 2, 2007, the Virginia College Building Authority (VCBA), on behalf of the Institute, issued \$1,650,000 of section 9(d) debt, Series 2007B. Proceeds from the bonds will be used to partially refund principal and interest payments related to Series 2002A bonds. Refunded principal totaled \$1,585,000. The note obligations between the Institute and the VCBA related to this debt issue will be adjusted accordingly.



Commonwealth of Virginia

Walter J. Kucharski, Auditor

**Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218**

March 3, 2008

The Honorable Timothy M. Kaine
Governor of Virginia

The Honorable Thomas K. Norment, Jr.
Chairman, Joint Legislative Audit
and Review Commission

Board of Visitors
Virginia Military Institute

INDEPENDENT AUDITOR'S REPORT ON FINANCIAL STATEMENTS

We have audited the accompanying financial statements of the business type activities and aggregate discretely presented component units of **Virginia Military Institute**, a component unit of the Commonwealth of Virginia, as of and for the year ended June 30, 2007, which collectively comprise the University's basic financial statement as listed in the table of contents. These financial statements are the responsibility of the Institute's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the component units of the Institute, which are discussed in Note 1. Those financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinion, insofar as it relates the amounts included for the component units of the Institute is based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of the component units of the Institute that were audited by other auditors upon whose reports we are relying were audited in accordance with auditing standards generally accepted in the United States of America, but not in accordance with Government Auditing Standards. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the business type activities and aggregated discretely presented component units of Virginia Military Institute as of June 30, 2007, and the

respective changes in financial position and cash flows, where applicable, thereof for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages two through nine is not a required part of the basic financial statements, but is supplementary information required by the accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Virginia Military Institute's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Virginia Military Institute's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of Virginia Military Institute's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control over financial reporting. We consider the deficiencies entitled "Improve Logical Access Policies and Procedures" and "Properly Complete Employment Eligibility Verification Forms," which are described in the section titled "Internal Control and Compliance Findings and Recommendations" to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Institute's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed an instance of noncompliance or other matter that is required to be reported under Government Auditing Standards. This instance of noncompliance entitled "Properly Complete Employment Eligibility Verification Forms," is described in the section titled "Internal Control and Compliance Findings and Recommendations."

The Institutes's response to the findings identified in our audit is included in the section titled "Agency Response." We did not audit the Institutes's response and, accordingly, we express no opinion on it.

Report Distribution and Exit Conference

The "Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters" is intended solely for the information and use of the Governor and General Assembly of Virginia, the Board of Visitors, and management, and is not intended to be and should not be used by anyone, other than these specified parties. However, this report is a matter of public record and its distribution is not limited

We discussed this report with management at an exit conference held on March 18, 2008.

AUDITOR OF PUBLIC ACCOUNTS

JRQ:clj

VIRGINIA MILITARY INSTITUTE

LEXINGTON, VIRGINIA 24450-0304

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25 March 2008

Mr. Walter J. Kucharski
Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

Dear Mr. Kucharski;

The purpose of this letter is to provide responses to the two internal control and compliance findings issued to Virginia Military Institute during our 2007 fiscal year audit.

The VMI employee exit policy instructs the supervisor to notify the Human Resources (HR) Department prior to the employee's departure. In the event that fails, the supervisor is required to notify HR immediately or as soon as possible after departure. This implies the same day or next day notification. The policy will be amended to specifically state that the supervisor has seven days to notify HR of an employee's exit.

The policy will be modified to state that when immediate termination is required, a verbal notification from HR to Information Technology followed up with an email message is sufficient. Employee exit procedures will also be included in the mandatory security awareness training.

To address the internal control and compliance finding concerning the proper completion of Employment Eligibility Verification forms (I-9 Form) VMI will develop a policy to require full compliance and cooperation from all departments and will ensure that all I-9 Forms are reviewed immediately after completion for accuracy and correctness. These actions will be completed by 1 May 2008.

The I-9 Form verifies the eligibility of an employee to work legally in the United States. Employers are required to verify this employment eligibility for every employee hired. Most of the I-9 Forms for VMI employees are completed in the Human Resources Office and are filed separately from the individual employee personnel files.

Federal and state authorities have emphasized the importance of completing a form for every new employee and ensuring the employee has the proper documents to verify his or her eligibility for employment. The 43 page Handbook for Employers – Instructions for Completing the Form I-9, published by the U.S. Department of Homeland Security, devotes a third of its length to descriptions and illustrations of the



Mr. Walter J. Kucharski
25 March 2008
Page 2

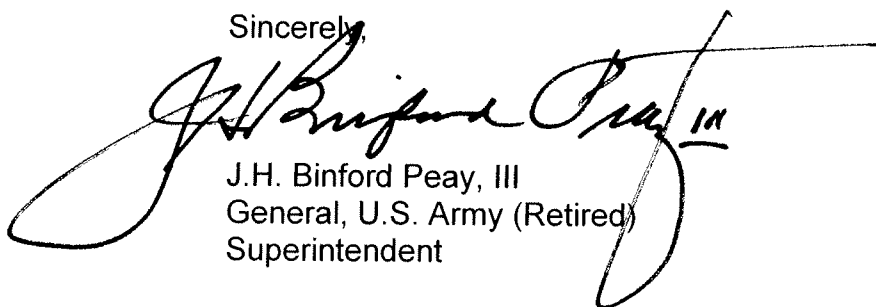
acceptable documents required to certify the I-9 Form. Less than a page of the handbook describes the completion of Section 2 (Employer Review and Verification). There is no state policy that addresses the completion of the form and the state has not offered any training on the requirement.

Of the sample of ten I-9 forms reviewed by the auditors, all the forms listed the correct documents to verify employment eligibility. Two of the errors noted were "correction not initialed/dated by the individual making the correction." The Handbook for Employers does not specify initialing a correction as a requirement. Four errors noted by the auditors were for the omission of the issuing authority and document number. These forms listed the employee's social security card, but did not note that the card was issued by the Social Security Administration, nor the document number. The I-9 Form records the employee's social security number in section 1. The remaining errors found by the auditors noted violations in the rules covering dates signed and certified.

The Handbook for Employers also notes any penalty for failing to comply with requirements would consider the good faith effort of the employer, the seriousness of the violation, and whether or not the individual was an unauthorized alien.

Thank you for the opportunity to provide our response to these issues identified by you and your staff during the course of our 2007 fiscal year audit.

Sincerely,

A handwritten signature in black ink, appearing to read "J.H. Binford Peay, III". The signature is fluid and cursive, with a large loop at the end. It is positioned above the printed name and title.

J.H. Binford Peay, III
General, U.S. Army (Retired)
Superintendent

VIRGINIA MILITARY INSTITUTE

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